

**CENTER ON CAPITALISM AND SOCIETY
COLUMBIA UNIVERSITY
<http://www.earthinstitute.columbia.edu/ccs>**

CCS Working Paper No. 25, May 2008

Dynamism and Inclusion: What? Why? How?

Edmund S. Phelps^{*}

^{*} Columbia University
e-mail: esp2@columbia.edu

Dynamism and Inclusion:

What? Why? How?

Edmund S. Phelps[†]

My thesis in recent years is that a just society requires the good economy; the good economy requires high dynamism and wide inclusion; and these qualities require a well-chosen mix of economic policies: some aimed at dynamism, some at inclusion. If further goals of economic policy are valuable, as productivity might be, either they derive value from what their achievement would add to dynamism or inclusion *or* their pursuit does not get in the way of dynamism or inclusion.

WHAT IS ECONOMIC DYNAMISM?

I began working with the concept of *economic dynamism* when doing research on the Italian economy in the late 1990s. By the dynamism of an economy I mean its *innovativeness* in *commercially viable* directions.[‡] It is important to note that episodes of rapid growth in a country or in the whole global economy can come purely from market opportunities of a transitory or exhaustible kind, such as Europe's fast growth from the mid-1950s to the mid-1970s when it had opportunities to pluck for its own use the low-hanging fruit of overseas technologies and business practices; so dynamism and growth are *not the same thing* and the growth rate is *not a measure* of dynamism. What, then, *are* the indications of dynamism?

[†] Given at the Inauguration of the Phelps Chair, School of Law, University of Buenos Aires, May 20, 2008, and the 20th Anniversary Fórum Nacional, Instituto Nacional de Altos Estudos, Rio de Janeiro, May 26, 2008. The author is McKim Professor of Political Economy, Columbia University, Director of Columbia's Center on Capitalism and Society and the Winner of the 2006 Nobel Prize in Economics.

[‡] My use of "dynamism" began in my reports for Italy's science foundation in the late 1990s, later published in Phelps, *Dynamism and Inclusion in the Italian Economy*, Springer Verlag, 2002. The same concept and term are at the center of the fine book by Virginia Postrel, *The Future and its Enemies*, New York, 2003.

Dynamism – or the lack of it – tends to manifest itself in a variety of ways. Higher dynamism in an economy delivers faster productivity growth most, if not all, of the time, so with time it leads to a consistently higher *level* of productivity. Dynamism creates a distinctive sector of economic activity: employment in the financing, development and marketing of new commercial products for launch into the marketplace; and a cadre of managers deciding what to produce and how to produce it. These added avenues for employment, it may be argued, generate higher levels of total labor force and total employment. There is also evidence that higher dynamism results in workers reporting higher job satisfaction and employee engagement. Finally, higher dynamism also tends to produce a relatively high rate of “turnover” in the members belonging to the economy’s largest firms, as some new firms grow large and displace old members.

In recent years I have been testing the hypothesis that dynamism is so important and the disparities in dynamism across countries are so pronounced that where a country ranks in the “league standings” with respect to productivity level, employment, job satisfaction, and turnover among the big firms is largely determined by the relative dynamism possessed by its economy – its economic institutions and economic attitudes. This hypothesis can be found in the writings of Friedrich Hayek, Alfred Chandler, Richard Nelson, Roman Frydman and Andrzej Rapaczynsky, and Amar Bhidé, to name some seminal contributors.

Much of the general public, though – in the United States and elsewhere – are under the belief that high productivity and job satisfaction (there is some debate about job creation) are driven by the great technological advances of scientists and explorers. Productivity growth and many jobs would gradually vanish were it not for the occasional *dues ex machina* from outside the economy – a Christopher Columbus, a James Watt, an Alessandro Volta or a Michael Faraday. That view underlies the model of innovation in the 1911 book by Joseph Schumpeter, *Theory of Economic Development*. In this model, the Schumpeterian entrepreneur considers the many unexploited opportunities for new commercial developments

made possible by the previous discoveries of scientists and explorers and then the entrepreneur identifies the project that would best fit his or her abilities; the Schumpeterian banker inspects the entrepreneurial projects brought to him and ably selects the ones with the highest prospective profitability. No player in the economy conceives of anything that the other players have not conceived. The agents of change are all outside the economy. This view started with the German school led by August Spiethoff, who taught that innovation comes in great waves, each one linked to some new fundamental scientific breakthrough.

The historical record since the mid-19th century supports more the dynamism theory than the Spiethoff-Schumpeter theory. If they were right, we would see productivity growth arriving mainly in great waves; and, looking across countries with satisfactory property rights and rule of law, we would see only insignificant differences in productivity, job satisfaction and turnover among the big firms. But we do not see that. In Canada and the United States, there is an almost unbroken record of relatively high employment, high productivity and rapid turnover. Productivity in these countries is particularly remarkable for the *sustained* nature of its growth: it did not slow even during the Great Depression of the 1930s, though it was awfully slow between 1975 and 1990. Looking at other countries in the G10, we see in France, Italy and Sweden a strong rise of relative productivity, employment and turnover among the largest firms from the late 19th century till World War I followed by a decline during the 1930s that, in most respects, is still evident to this day. Both turnover among the largest firms and reported job satisfaction have been strikingly low in France and Italy; and in Sweden there have been no newcomers to the 20 largest firms since 1921.

Many who believe in the feasibility of dynamism in the economy maintain that dynamism can best be produced by a top-down system in which the state fosters technological advances that will in turn give inspiration and a competitive advantage to national firms. This was the strategy of Italy when in the 1930s it instituted the *Consiglio Nazionale delle Ricerche* and the strategy of France (and to

a lesser extent Germany) where nationalizations established some giant state-owned enterprises that were allowed, even encouraged, to produce technological advances in their laboratories.[§] But the impression of many experts is that little dynamism tends to result from society's investments in this "techno-fetishism," since so little business expertise and commercial calculation – and so much self-dealing – goes into the proposals and selections of scientific projects. Even if scientific projects in one or more countries did boost productivity by enough to cover the investment cost, the increase in productivity would be miniscule next to the potential contribution that improving business practice could make. Productivity in Italy, France and Germany during the 1920s and 1930s fell far behind productivity in the U.S. in spite of an abundance of scientists. Productivity in the Soviet Union lost ground to rival economies in the 1970s and 1980s in spite of a heavy expenditures on scientific research. These economies could have *pockets* of creativity – researching rockets, Sputnik, bullet trains and later the Concorde – but the creativity did not pervade the commercial sector, so there was no financial and managerial discipline that could bring cost management and, above all, strategic vision: seeking the highest returns without fear of failure.

If it would take a supernatural leadership by the state to generate much dynamism, how is it that some countries generate dynamism? What is their secret? The existing theory, beginning with work by Friedrich Hayek in the 1930s, argues that appreciable dynamism in the creation and adoption of new commercial ideas can be generated by an intricate *system* with six *bodies* of actors: a *diversity* of conceivers, or dreamers, of new commercial ideas each drawing on his or her unique experience and private knowledge; a *diversity* of enterprising figures each well matched to his or her developmental project by virtue of his or her unique background and talent; a *diversity* of financiers each with a contrasting experience and education for use in selecting which projects to back and nurture; and a *diversity* of managers and consumers some of whom will have the preparation and

[§] In the U. S. as well, a report just last year by the National Academy of Sciences and another this spring by David Baltimore urged the federal government to expand state-sponsored scientific research on the stated grounds that it would quicken productivity growth in the American economy.

specialized background to pioneer the adoption and mastery of a new method or products. (Even if the system is in place, it can be blocked.)

In some of the countries having economic institutions of the *capitalist type*, just this system for dynamism is found in relatively unfettered operation. With the key freedoms protected by the rule of law, participants will sort themselves out among the six bodies: some participants will step forward with new commercial ideas; some of them or others will each take up an entrepreneurial project to develop a new idea into a marketable product or method; still others will make the decisions to finance some of these projects and refuse others; finally, many will act as end-users, as managers and consumers evaluating new products and methods and sometimes pioneering their adoption. It may be that the system for dynamism is *also* found in some other type of economy – perhaps some more “cooperative” type of economy. But before we come to economic policies for dynamism we first have to consider whether dynamism is something that is really required for a good economy, whatever its full description.

THE GOOD ECONOMY: DYNAMISM WITH INCLUSION

A great many people are very unsettled by such a system: they feel pulled along by a headless horseman. It is true that an economy of considerable dynamism is on an *indeterminate* course: it is indeterminate because there is no way to determine in advance what the new ideas yet to emerge and be developed in the economy will be. Hence the participants themselves cannot fully know what will be the results of their own innovations and, even more, the unforeseen innovations undertaken by others. More precisely, even the *probabilities* of the known influences on the outcome are not known and not all the influences are known – a situation called *Knightian uncertainty*. A lot of people have no appetite for being entrepreneurs once they understand that entrepreneurs need “animal spirits” – that to commit to a really innovative project is to “leap into the void.”

Numerous observers, including me, have described how uncertainty manifests itself and the kinds of challenges it presents in setting monetary policy, managing a business and so forth. There are hazards in acting, which most businesses must often do, with limited understanding. In the past dozen years we have seen blunders in monetary policy, regulatory mistakes, astonishing financial losses, and worldwide financial crises that are a result of imperfect understanding. This sort of uncertainty and the resulting “instability” are widely seen as an *objection* to economies possessing appreciable dynamism. Capitalism was widely seen as receiving a “black eye” when the U.S. financial system contracted in 2007.

The other objection to dynamism is that it causes inequalities in wealth that have no immediate or obvious defense. They seem morally arbitrary. There is also in some countries noticeable hostility to anyone’s succeeding to become rich – much more than to anyone’s being rich. If a person inherits great wealth it is not his fault – perhaps it was hard to avoid it without causing offense. It is seen as part of the *downside* of an economy of dynamism that it is a system in which people dream – dream of wealth, fame, whatever – and while some succeed many fail, for no fault on their part.

What kind of reply can be made to these two objections? Is the choice between an economy of dynamism with its attendant uncertainties and inequities and an economy of tradition with its attendant routine and familiarity simply a matter of taste? Or are there some fundamental principles involved?

I saw that there is a very basic consideration that must not be ignored. Dynamism opens the door for participants to engage in novel activity – the conception, the financing, the developing, the marketing and the adoption of products and methods not known before. This is an economy in which entrepreneurial types are free to seek opportunities to exercise their creativity by venturing something innovative; and financial types can exercise their judgment.

Is this so crucial as to trump concerns over uncertainties and inequalities? Humanist philosophy, as I read it at any rate, suggests that, whatever the other dictates of justice may be, an economy cannot be a just economy, or good economy, if it does not permit and facilitate the good life; so the answer may lie in what we take the good life to be. There is a classical conception of the good life that originated in ancient Greece and has continued to evolve even in the 20th century.

In humanist thought, the classical conception of the good life originated with Aristotle in ancient Greece and has continued to evolve right through the 20th century. Aristotle saw the good life was one devoted to the acquisition of knowledge – not that everyone could afford such a life. Aristotle was followed by a school of humanists who might be called pragmatists. Virgil, a poet of ancient Rome, celebrated the human capital acquired by the Roman farmer. Later there was Voltaire, and in the 20th century John Dewey and John Rawls and Amartya Sen.

A parallel school of humanists are the vitalists: starting with Benvenuto Cellini in Renaissance times and Cervantes in the Baroque era and continuing on to William James and Henri Bergson early in the 20th century.

This humanist tradition clearly implies that dynamism, even though it is a cause of some irremediable fluctuations and some irremediable inequalities, is necessary for the good life. An economy of dynamism meets some of our very basic needs: to exercise our imagination, to enjoy the mental stimulus of change, to have an endless series of new problems to solve, to expand our capabilities, to feel the thrill of discovery, and to sense our personal growth. The primary importance of this “self-realization” and “self-discovery” surely trump the point that such a life poses uncertainties and the risk of failure.

Well-accepted notions of economic justice imply that *economic inclusion* is also necessary for a good economy. When, in the early 1990s, I began urging government measures to increase inclusion, my argument was Adam Smith’s point

that you will be more effective in trying to raise a person's income if you enlist his self-help alongside your own contribution rather than simply to throw money at him unconditionally, which would probably diminish his motivation to earn additional income. I wrote in my 1997 book *Rewarding Work* that people of sound mind and body who are unable to gain employment or are in and out of employment for any of a variety of reasons suffer a loss of dignity, of economic independence and of the sense of belonging to the central project of society. And they need the money.

Yet in that book I also saw that inclusion is of primary importance in part because, for most people, jobs are virtually the only source of mental stimulation, problems to solve, expansion of talents and self-discovery that people are likely to find. Because the more fortunate of the advanced economy are full of dynamism, it is particularly important in those economies that people be able to participate in the economy. Justice, John Rawls would have said in this context, requires society help people into jobs lest they be deprived of any prospect of "self-realization."

So the moral necessity of dynamism and the further moral necessity of inclusion *if the economy is one of dynamism* spring from a common consideration. It is a kind of death not to be able to have a career of challenge, change and personal growth – which only a career can provide. The evidence does not bear out the claim that family can deliver the same rewards. Data show that reported happiness does not increase with the number of children!

I go on to argue that dynamism and inclusion are largely non-competing. Dynamism boosts inclusion. The reason is that dynamism creates jobs and raises wages in the process, which benefits everyone – including the marginalized and the disadvantaged. I have also come to see that inclusion can boost dynamism. The entry of the marginalized and the disadvantaged into the economy increases the diversity of the participants, thus opening up added sources of new commercial ideas. That may be why a society's outsiders look surprisingly more creative to us.

ECONOMIC POLICY

The biggest threats to the good economy – to dynamism and to inclusion – seem to me to be the same three dangers throughout the western world. A classical kind of rhetoric in defense of the welfare state holds that welfare payments bolster people against market forces so that we can have a “market economy.” The successful pressure to legislate additional welfare entitlements to “cushion” the middle class and the elderly from everything, even death, drives out economic policies (actual or potential) to preserve or foster dynamism and inclusion. These entitlements are not a left-wing conspiracy to soak the rich – the rich hardly care about the modest increase in tax rates on payrolls. They are more nearly a right-wing conspiracy to buy the solidarity of the middle class at the expense of government efforts to build an infrastructure and a regulatory system aimed at raising dynamism and government efforts to build an education system and a wage subsidy system aimed at raising inclusion. Some economists think that this welfare state is not a burden on society’s capacity to do other things as long as the middle class sees the entitlements as worth the taxes paid; but this is terrible economics: the receipt of the new entitlement is itself a burden by weakening employee loyalty and zeal, thus aggravating unemployment and reducing incentives to stay in the labor force. In the struggle between Hilary Clinton, who campaigns for welfare, and Barack Obama, who campaigns for work and development, I know perfectly well which side I am on!

Another threat to dynamism and to inclusion is the pressure from “stakeholders” and the “social partners” to limit the property rights or incentives of entrepreneurs, financiers and managers to make innovations – innovations that would involve downsizing an existing business facility, or require new ownership of a company or require CEOs exert discipline over featherbedding and nepotism, or require shareowners to discipline the CEOs, etc. The postwar and interwar economic history of western continental Europe (and some other nations) provides powerful evidence for the thesis that private ownership with only vestiges of scope and control on the part of the owners, owing to social pressures, is disastrous for

dynamism, and thus for high employment and job satisfaction. This is an old story: the struggle between *Gesellschaft* and *Gemeinschaft* – business and community.

The pressure on politicians to refrain from opening the economy and even to take steps in the direction of less openness is not just bad policy from a neoclassical standpoint – from the viewpoint of free trade advocates. This pressure also operates to reduce dynamism, which is much worse than lowering real incomes a few percentage points. Taxes that restrict imports and taxes that restrict exports, such as Argentina's notorious *retenciones*, both operate ultimately to narrow *both* exports and imports. In doing that, these policies have the effect of narrowing the size of the market for entrepreneurs, actual or potential, when they are deciding whether to innovate or not. So policies in a country structured to constrict the scale of its foreign trade operate in this way to reduce dynamism.

I would also argue that economic policies in a country that are profligate or hostile to competition or to foreign capital, so that the country's currency is weakened, also reduce dynamism. A real exchange rate depreciation increases the shield that domestic producers have from foreign competitors. That, in turn, induces all or most of these producers to raise their mark-ups – in short, to act more like monopolists and less like competitors. This is just like a contraction of supply and one effect is a cutback of employment, which I think is confirmed by some statistical studies. Another effect is to induce domestic firms to cut back their innovative activities, since, at least for a time (until the increase in customers makes up for the reduced supply to all), the size of the market has shrunk.

I am not a “neo-liberal.” An optimal set of economic policies is not orthodox in every respect. Programs to nurture dynamism and subsidize inclusion are required. Yet a wholesale failure to prize work and enterprise over welfare benefits, to favor real owners over stakeholders and social partners, and to support openness over protection will prevent any country from achieving high economic performance and doing well in the international competition for influence and prestige.